

The nudge factor

Why B-schools students should understand the incentives of ignorance, dodgy marketing and crisis pricing

Subrato Banerjee

THE idea of effectiveness of an incentive in stimulating action is unquestionable. What is often questionable, however, is the underlying execution. The second price auction mechanism, for example, introduced by Vickrey, eliminates any incentive to overstate or understate one's own valuation—no incentive remains for a participant to lie. Introducing the wrong incentives, however, can also have undesirable consequences. We're immediately reminded of a day-care centre example discussed in the famous book *Freakonomics* by Levitt and Dunbar where an introduction of a fine on parents who picked up their children late actually increased the incidence of late pick-ups even further. In this article, I discuss the power of incentives in the context of the recent global crisis—I propose yet another explanation to the recent crisis—one based on wrong incentives.

Great minds like Keynes observed that free market economies do function, but you need someone to oversee them. Let us closely focus on the sophisticated lot called investment bankers. The volatility in the US that observed vast numbers of mortgages (to people who couldn't afford them) on properties that were diminishing in value, was the sub-prime situation. Bird and Fortune provide a simple explanation—a mortgage salesman (hired by a financial institution) meets a pauper and says "buy this house ... and allow me to lend you the money" (incentive of *ignorance*). This debt is then bought by a bank and packaged with a lot of similar (dodgy) debts, which are then marketed under the name of structured investment vehicle or SIV (incentive of *dodgy marketing*). The investment banker then buys it from the bank to further sell to somebody elsewhere who buys it

for \$100 million, without the faintest idea of the product. This process of selling and reselling could happen over several cycles of transaction and each time this SIV is sold, an investment banker claims a mark-up over the price at which he himself buys it (incentive of *crisis pricing*—or to combine those words ... '*crysing*', a term that also combines the words *cry* and *sing*—when the investor *cries*, the investment banker *sings*). This is what defined the market. Let us discuss these incentives in detail.

Incentive of *ignorance*: The idea behind this can be best explained by the general belief held by finance economists. Even as early as the 1980s, finance economists, notably Michael Jensen of Harvard Business School, argued that because financial markets always got prices right, the optimal strategy for corporate chieftains beyond their own self interests, i.e., for the sake of the economy, was to maximise their own stock prices. Stock prices would rise only if there is adequate (speculative) demand for the same, and this demand in turn would become effective only if people had ready liquidity, i.e., money supply—precisely the reason why the investment bank, through our mortgage seller, was willing to provide a loan to the pauper. The investment banker, therefore, devises a payment scheme for our mortgage salesman such that it is in the latter's own interest to provide as many loans as possible. The mortgage salesman's income depends entirely on the number of mortgages that



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he manages to arrange and not necessarily on the quality of the same. The incentive to overlook factors such as creditworthiness of borrowers thus becomes

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unquestionable. As Krugman put it, the capital development according to finance economists should be put in what Keynes called a 'casino'.

Investment banks, however, took little caution against possi-

ble risks of default. The social milieu, according to Eichen-green, "encouraged financial decision makers to cherry-pick the theories that supported excessive risk-taking." Business schools, through their students' career development plans, aim at high incidence of placements. This objective is largely met when business schools cater to the needs of firms belonging primarily to booming industries. Investment banking met that qualification. (I define a booming industry as one with high demand for what it sells—regardless of whether such demand created is genuine or artificial.) According to Eichenngreen,

"soon after, business schools jumped to supply graduates to write those (how much would a firm lose if tomorrow turned out to be a bad day) reports ... and value at risk (VAR) as that number and the process for calculating it came to be known, quickly gained a place in the business-school curriculum." What was ignored is that VAR needs exceptionally skilled and careful analysis and the chances of reaching a less skilled practitioner would only increase with higher availability of such practitioners. To top it all, hiring such graduates from premier business schools only had the effect of raising employee costs, thus adding to the liability of an investment bank precisely when faced with the possibility of a melt-down.

Incentive of *dodgy marketing*: This refers to false marketing of products that generate artificial demand. An obvious question

strikes—if the financial products in question were really the low quality kind, how were they really sold? This is where the power of marketing comes in. The idea of good marketing is practically identical to that of making a customer buy something that he really doesn't need. The fact is that most of the dodgy instruments had pretty fancy names. To provide an example, if one were to suggest marketable names, one would choose words such as leverage, structured, enhanced, and if I may add, high-grade. Elementary statistics will suggest that the mere presence of such words in the names of instruments significantly increases the chances that they'll be purchased. For reasons mentioned before, the very instruments with fancy names were the ones with sub-standard performances. The key takeaway from here is that most of the investments were on fancy instruments and most of the fancy instruments in turn failed to perform—to put in a nutshell, most of the investors lost their money.

Incentive of *crysing*: This is perhaps the most important point. Investment bankers saw themselves blindly caught in the temptation of charging a mark-up over the generated instrument each time it exchanged hands. The final holder of that instrument, thus, must have paid an amount exorbitantly higher than its actual worth. The general confidence on the intellectual capacity of investment bankers led the final holders to simply accept the terms without questioning the actual worth of the underlying asset (not many, for example, asked how much were the houses in the US worth at the first place). The general stupidity hadn't been revealed and the consequences were inescapable. We all know what happened next.

The author is a research scholar at the Indian Statistical Institute

This way up

We are essentially looking for a 'duty to serve' mindset

WE believe that we are in people-business, and we do so with prudent 'business' sense—above everything else, it's our people who make LeasePlan the 17.5-billion euro leader in the vehicle leasing and management industry across 30 countries.

The above mentioned belief is also the fountainhead of our hiring approach.

If I have to answer the question "what do we look for when we hire" in one line, my answer will be: "We hire for LeasePlan value fit, LeasePlan culture fit and application of mind ... generally in that order." This, apart from, of course, the intelligence quotient and emotional intelligence quotient requirements of not just the hiring role, but preferably also for the next two levels. I hope you will notice the use of LeasePlan as an adjective. It's a way of life for us. Let me share glimpses of this way of life and of what makes a true LeasePlanner, as we like to call ourselves.

Passion: Interestingly, the interest area could be in any field, within or outside the specific work area. Golf, dance, car racing, trekking, quizzing, excel spreadsheets, gizmos ... we have a remarkably diverse set of examples that have proven and confirmed our hypothesis that this quality goes into building a mindset of constant learning and "being the best in what I do" ... and extrapolates even at work. Of course, we continue to support these interests as far as possible.

Respect: To borrow the saying, for people, planet and profits. Actually, it goes beyond that. It's about sensitivity, about empathy, about tolerance, about equal opportunity and about treating others the way we want to be treated.

Initiative: In the real life scenario, we need to put our people in 'live fire' where new capabilities can, and must, be acquired. Hence, we look for demonstrated examples where applicants have shown initiative to be a part of a change process, a thought leadership forum or held a leadership position, to name a few examples.

Systems thinking and application of mind: I would put this as the most important quality because it gives us the edge to reduce errors, constantly innovate and constantly raise the bar of service delivery. It's a rare one, too, especially in the early years of a person's career. We define this as the ability to

IN THE REAL LIFE SCENARIO, WE NEED TO PUT OUR PEOPLE IN 'LIVE FIRE' WHERE NEW CAPABILITIES CAN, AND MUST, BE ACQUIRED. WE LOOK FOR DEMONSTRATED EXAMPLES WHERE APPLICANTS HAVE SHOWN INITIATIVE TO BE A PART OF A CHANGE PROCESS

look and reason beyond the obvious. It requires a questioning mind and a logical and 360-degree perspective to problem solving. The good news is that it's an acquired quality.

Integrity and ethics: This one needs no explanation and we do not negotiate. It's a way of life. Period.

Teamwork: If we hear a player from a team sport, we will know what it means when he/she says that the team comes above the self. At LeasePlan, too, we place interdependence above independence. There are actually very, very few roles that I can think of that can work in a silo. Most of the time it's a collaborative effort that culminates in stellar outcomes. A good team player is definitely an asset.

Ability to be comfortable in an environment of flux and seamless boundaries: This is the moment of truth for most companies today and we are no exception. The ability to stay focused even in ambiguity and deliver exceptional service even amidst scarce resources is a hallmark of professionalism. We look for that.

And above all, since we are a service-centric organisation, we look for a positive attitude and a 'duty to serve' mindset. Irrespective of any function, level or role.

It's no surprise that LeasePlanners live the HR mission: Each employee makes a difference each day.

The author is HR Head, LeasePlan India Limited



CHARU DEWAN

SUCCESS ALLEY

How Kerala became God's country

A POPULAR advertising campaign communicates the benefits and projects a positive perceived value for the customer. In India, Kerala—"God's Own Country" and Goa—"God's Own Holiday Destination"—have been popular campaigns used to promote and demonstrate the customer benefits associated with the location. Advertising did the trick for these two tourist destinations.

Kerala was a relatively unknown destination, as most tourist circles focused on North India, especially Agra and Rajasthan. After the early

1980s, Kerala Tourism Development Corporation, the government agency that oversees tourism prospects of the state, laid the foundation for the growth of the tourism industry.

Through upland marketing strategy, within a few decades, Kerala's image got transformed as one of the top holiday destinations in India. The tagline "Kerala—God's Own Country", originally coined by Dr Vipin Gopal, who created the first Web page on Kerala, has been widely used in Kerala's tourism promotions and soon became synonymous with

the state. Marketing is, indeed, alive and well in the world of tourism. In fact, it is on the upswing, and more and more states in India are leveraging advertising to attract tourists. Relevant Web sites are created and promoted. The Web sites provide easy access and, hence, a convenient medium for getting information on the attributes and features of the offerings.

Excerpts from 'Tourism Marketing' by Devashish Dasgupta, associate professor, IIM, Lucknow



ASIT BAGCHI

CAMPUS ROUNDUP

School of Management at University of Southampton offers PhD scholarships

The School of Management at UK's University of Southampton is offering five PhD Scholarships for full-time entry for the session starting from September 29, 2011. The School of Management is internationally recognised as one of the UK's leading centres for management education and research. The scholarship applications will be considered for undertaking research in any area of management, including accounting, banking, CSR, health management, HR, innovation, management science, etc. One of the scholarships will specifically be awarded for the area of 'Quantitative Management Science/Operational Research', involving research in green logistics and transport, healthcare, optimisation and heuristics. Each scholarship is worth £11,000 and will be awarded on the basis of academic excellence and research potential. The completed applications received by April 1, 2011 will be considered.

Indian Retail School again rated the best retail management institute

Indian Retail School, one of the most recognised retail management schools in India, has recently been rated as the best institute for offering industry specific retail management courses. According to Tarun Panwar, CEO, Indian Retail School, "It is an achievement to be top ranked in providing industry specific knowledge to the students who aspire to be a part of the retail industry. We are constantly upgrading our facilities so that more professional training and practical

knowledge can be instilled in the students, which would help them to face the challenges in future."

MDI to host conference on digital libraries and knowledge organisation

Management Development Institute will host the first International Conference on Digital Libraries and Knowledge Organisation from February 14-16, 2011. The conference will provide a platform to the world's leading academicians,



researchers and professionals to exchange ideas and share research findings in the field of digital information systems. The 3-day conference is being organised in association with Indian Association of Special Libraries and Information Centres, INDEST-AICTE Consortium, Ministry of HRD, UNESCO, GOETHE-INSTITUT and South Asian Studies Council, Yale University at Gurgaon campus.

We invite colleges and universities to send in information—on new faculty, courses, alliances, projects and other events—for this section. E-mail: vikram.chaudhary@expressindia.com

CAMPUS OF THE WEEK: DEPARTMENT OF BUSINESS ECONOMICS, DU

fe@campus, a collaborative and cynosure initiative taken by The Financial Express in sync with a variety of higher education institutes representing today's youth, provides students an opportunity to open their views on trends and



An initiative by The Financial Express

trendsetters in the world of business. For this week, we put forth the topic: "How equipped are Indian firms in making sustainable acquisition overseas?" Students of the Department of Business Economics, DU, sent us their essays. Here is the best one:

THEME OF THE WEEK: HOW EQUIPPED ARE INDIAN FIRMS IN MAKING SUSTAINABLE ACQUISITION OVERSEAS?



Post-recession M&A scene bright for India

Aparajita Sinha

THE Indian economy has been transforming into an economic superpower by virtue of enterprising business managers who have been anchoring corporate India on the path of economic development, amidst all obstacles coming their way, be it the political environment prevailing in the country or the adverse economic conditions.

Until the 1980s, the role of Indian multinationals in the international corporate scene mostly involved either undertaking cross-border greenfield investments or getting acquired themselves. Post-liberalisation, things started changing and then came the year 2006 when we witnessed the \$12.04 billion Tata-Corus deal. Suddenly, M&A became the preferred route taken by India Inc to foray into the international market.

begin with, the success of an acquisition depends on how each party benefits. To sustain an acquisition, it is important that both the parties involved find the arrangement mutually beneficial. The efforts expended by the senior management team in managing the integration and taking it through, amidst vast cultural differences, also plays a major role in the post-acquisition performance of the unit. India has an edge over other countries, as far as making sustainable overseas acquisitions are concerned, due to the availability of a large pool of English-speaking business professionals, convenient geographic location and exposure to the international arena of business. Some factors, such as corporate governance, need to be strengthened, particularly in light of the Satyam fiasco, after which there will be no doubt about India's capability in making sustainable overseas acquisitions.

It must also be mentioned that looking back over the past 3-4 years and the spate of big ticket acquisitions that took place, there have been instances when Indian companies were susceptible to policy changes and regulatory interventions (in the foreign country).

The author is MBESTudent at the Department of Business Economics, University of Delhi